GATO CORPORATION

Oil and Gas Development

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Royalty Management Program
Minerals Management Service
P. O. Box 25165, MS 3101
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Subject: Crude Oil Valuation

Dear Sir:

Gato Corporation is a small, family-owned, single-lease independent producer of about 60,000 bbl/year of heavy crude (11°API). None of this production is from federal leases. As such, we have no standing in the on-going federal lease royalties discussions. However, our company and our minerals owners have also been adversely affected to a significant extent by the current price posting system. We fully support the MMS's efforts to find a replacement crude oil valuation system. Although initially focused on federal leases, the replacement valuation system will hopefully be of sufficient probity to be accepted throughout the domestic crude oil marketing system.

We have written the MMS of our concerns about the posting system and its effect on federal royalties several times in past years. We have corresponded on this subject with the Departments of Energy and Commerce, and discussed it with the staff of Sen. Max Baucus. A system in which prices are established by the purchasers is, by definition, biased, especially when the purchasers control the cross-country pipelines and ignore the terms of their pipeline easements across federal lands. A system where independent purchasers post identical prices at the identical hour of the identical day raises obvious suspicions of collusion. Similar arrangements among commercial airlines and among agricultural chemical producers have been prosecuted and outlawed. The problem is magnified when artificially low federal offshore lease postings are used to drive down price postings for near-by onshore small producers. Many of our concerns were confirmed by the findings of the Interagency Report.[1]

A clear distinction should be drawn between "large" and "small" independent producers. As noted in the Interagency Report, price differentials are paid to large independents but not to small independents. A differential of $1-$3/bbl would have a major impact on small producer P&L statements. Lobbying groups survive on the contributions of their constituents. The contributions affordable to large producers may be 10 to 100 times the

[1] Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California, May 16, 1996.

contributions affordable to small producers such as ourselves. As a result, the needs and views of small producers are generally ignored if not compatible with those of their larger counterparts. Their absence is prominent in the industry comments submitted during the primary and extended comment periods on the MMS-proposed oil valuation rule. Especially illuminating is the API comment that the supplemental proposal was "disappointing because it was limited to a few small producer-oriented tweaks."

The Royalty-In-Kind alternative may be a viable alternative for federal leases, but certainly not as a general replacement valuation system applicable to all producers. On federal government leases, there is one lessor –the federal government. However, in commercial leases the royalty interests may be owned by many charities, trusts, individuals, etc. scattered around the world. The courts have generally found[2], in the absence of a provision to the contrary, that such interests are held jointly. An RIK election would require unanimous consent. In many cases, such an election would be very difficult to accomplish administratively.

Restrictions on the sale of RIK oil should also be examined. In early 1994, on behalf of local small producers we proposed[3] to the MMS that we be permitted to purchase Pt. Arguello RIK crude at its posted price which we would then blend with native on-shore crude. The blended crude would substantially improve small producer price margins at no cost to the federal government. The crude would be of pipeline quality, thereby improving its marketability and permitting substantial reductions in air pollution, highway hazards and congestion. As part of our proposal we offered to pay 25¢/bbl to the California Division of Oil, Gas & Geothermal Resources for its use in funding the abandonment of deserted wells, of which there are thousands in California. Our proposal was rejected on the basis of federal limitations on acceptable purchasers of federal RIK oil.

We believe that the existence of two separate crude oil valuation systems, one for federal crude and another for commercial crude, will prove to be untenable. There will be too much opportunity for mischief. We support the MMS's attempt to define a replacement system. We ask that the needs of small producers be considered in MMS's assessment of alternatives. Small producers make a significant contribution to national crude oil production and have been badly served by the current price posting system.

Respectfully submitted,

Robert E. Kendall

Robert E. Kendall
Managing Director

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[2] Jameson v. Chanslor-Canfield M. Oil Co., 176 Cal. 1 (1917).
[3] R. E. Kendall to Mr. Tom Fry, Director MMS, *Point Arguello F-OCS Crude Oil Prices*, January 22, 1994.